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# America's Experience with Mergers: Is it Relevant Under Indonesia's New Competition Law?[1]

**by Paul H. Brietzke[2]**

I am grateful for the opportunity to address this Seminar, which deals with one of the most difficult areas in competition policy worldwide. Indonesia and the U.S. are very different countries of course, with different legal traditions and different problems and potentials in the area of competition policy. Nevertheless, Indonesians can arguably profit from a study of the experiences of Americans, and others of course. The U.S. was the first country to attempt a systematic approach to competition policy, beginning in 1890, and the Americans' "learning curve" was thus both steep and long. Living in a "late industrializing" country, Indonesians can review the history of policy dilemmas faced by Americans (and others), to focus Indonesian thinking and to avoid some analytical mistakes. I won't bore you with the specifics of an American, common law-style of case analysis that is not primarily relevant in Indonesia.

Compared to agreements that restrain trade and that are prohibited by s. 1 of the U.S. Sherman Act of 1890, and by Art. 4-16 of Law No. 5 of 1999, mergers involve a more complete and permanent integration of the parties' economic activities. Internal pressures (i.e., cheating within a cartel) often force the disintegration of an agreement among independent firms, but a merger is potentially forever. While a merger thus creates a greater hazard to competition (reducing output so as to increase price) than such an agreement, a merger creates a policy dilemma by also promising a greater economic efficiency in many instances. How these higher costs and benefits are balanced at the margin is a lively topic of policy concern worldwide.

Under s. 7 of the U.S. Clayton Act of 1914 (a reaction to failures in the competition policy of the Sherman Act of 1890, a reaction which was significantly amended in 1950), "merger"—the purchase of some or all of the assets or shares of one firm by another—also covers "consolidation"—a new firm owning the assets of formerly-independent firms—and stock acquisitions generally. (Such acquisitions may not lead to control over another corporation, but no opportunities for increased economic efficiency are then created.) S. 7 thus corresponds with Art. 27-28 of Law No. 5 of 1999, while the subject matter of Art. 26 is regulated (with an exemption for smaller firms) by a prohibition on "interlocking" corporate directors under s. 8 of the Clayton Act. The relevant language

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of s. 7 is as simple to state as it has proved difficult to interpret: a merger is prohibited in the U.S. when it "*may…substantially…*lessen competition." The "may" has been interpreted to require that the enforcement authorities prove a probability rather than a certainty of reduced competition, while "substantially" is taken to mean a serious reduction in competition.

### *Types of Conduct Regulated*

As in the competition policy of many other countries, the U.S. classifies and regulates three types of mergers under Clayton Act, s. 7: horizontal, vertical, and conglomerate. A *horizontal merger* involves two or more firms producing the identical or quite similar products in the same geographic market. Americans would treat a merger between bakeries located in Jakarta and Denpasser as a conglomerate merger, *infra*, on the assumption that they operate in different geographic markets. But market definition issues are often difficult: if a Jakarta detergent manufacturer acquires a Jakarta bleach manufacturer, is this a horizontal merger in the "laundry products" market or a conglomerate merger in separate product (detergent and bleach) markets? American law judges horizontal mergers with greater strictness than other types of mergers: they directly reduce competition, they may create substantial market power, they may facilitate the coordination of pricing and output decisions with competitors—even without a formal agreement, *and* they may increase economic efficiency. *See infra.*

A *vertical merger* involves an integration forward or backward in the chain of production and distribution, through the acquisition of a customer (a manufacturer acquiring one of its retailers, for example) or a supplier (an electricity generator acquiring one of its suppliers of coal, for example). Such a merger does not reduce the number of economic actors in a particular market, but it may change patterns of industrial behavior. Despite a great potential for increased economic efficiency and a limited capacity for economic harm, such vertical mergers were treated quite harshly in the U.S. from 1960 to 1980. The reasoning was that vertical mergers foreclosed competitors from access to the customer or supplier that "disappeared" as a result of the merger. This was seen as a barrier to entry: a potential manufacturer has to also enter markets as its own customer or supplier. These rather strict legal doctrines are now widely seen in the U.S. as based on the policy mistake of trying to protect small businesses: of protecting competitors rather than competition, since independent customers or suppliers will appear as soon as new business opportunities appear.

A *conglomerate merger* usually involves a product extension—a cigarette company buying a food processor, for example—or a geographic market extension: the Jakarta bakery buying a bakery in Denpasser, for example. Such mergers are treated differently from joint ventures: two or more companies getting together to create a product or exploit a geographic market which is new for both of them. Conglomerate mergers were seen as a (relatively small) competitive threat in the America of the 1960s and 1970s, but there has been little recent enforcement activity. They have no direct effect on competition and their effect on *potential* competition is usually pure guesswork, unless it can be proved that, but for the merger, the cigarette company would have begun processing food or the

Jakarta bakery would have begun producing in Denpasser. On the other hand and in comparison with other merger types and joint ventures, conglomerate mergers offer the fewest opportunities for an increased economic efficiency. "Conglomerates" seem to be topic of political as well as policy interest in Indonesia, so it may be difficult to develop optimal rules for such relatively low cost/low benefit conglomerate mergers—where their political influence is otherwise controlled.

*Historical Sketch*

The effects of the steep learning curve associated with American competition policy are that regulatory efforts begun in 1890 became effective with regard to agreements restraining trade (Sherman Act, s.1) only in 1927-1940 (*Trenton Potteries* and *Socony-Vacuum* cases), in 1945 for monopoly (Sherman Act, s.2, as interpreted in *Alcoa*), and in 1960 for mergers (Clayton Act, 1914, s. 7, as amended in 1950 and interpreted in *Brown Shoe*). The oligopolistic structure of many American industries is frequently blamed on this relatively late date for an effective merger policy. (Merger enforcement actions in the U.S. are often said to be like "locking the barn door after the horse has been stolen.")

The structure/conduct/performance paradigm in industrial organization economics dominated competition policy thinking in the U.S. of the 1960s: analyses showed that concentrated markets automatically generated inferior, uncompetitive economic performances. Mergers increased market concentration, and they were thus prohibited in all but the most competitive markets. But the "New Learning" in competition policy, sponsored by the Chicago School of neoclassical economics, contradicted much of this paradigm, only to face competition from a "post-Chicago" approach by the mid-1990s.

American competition policy, and merger policy in particular, has zigged and zagged in response to these fads in an academic economics, but a few generalizations about contemporary American thinking can be offered. There is increased emphasis on economies of scale and scope and on efficiency as ways to increase consumer welfare (a popular goal in a democracy), and on the means by which mergers increase *and* decrease efficiency and economies of scale. But American policymakers also recognize that market definitions, and predictions of future efficiencies, costs, prices, outputs, and barriers to entry, are relatively crude and unreliable. The party bearing the burden of proving such matters during an enforcement action is thus more likely to lose than in the past. In general, markets are now defined more broadly, and the merging parties must account for a larger share of a more concentrated market before the merger is prohibited. Critics argue that these tendencies ignore relevant Supreme Court decisions from the 1960s and the early 1970s, and ignore the legislative history of the 1950 amendment to Clayton Act, s.7.

*Policy Dilemmas*

Herbert Hovenkamp sums up: American merger policy revolves around the dangers of an express or tacit collusion among competitors—a collusion that arises from a merger which increases concentration in an oligopolistic industry--versus the potential efficiency gains from that merger. The dilemma arises from the fact that many real-world mergers display both of these tendencies, in varying degrees and to an unclear extent. Efficiency gains can occur in manufacture, r & d, distribution, management, and the market for corporate control, but sobering empirical evidence shows that these theoretical efficiency gains often do not emerge in reality.

For example and in theory, the threat of a takeover by way of a merger encourages management to be as efficient as possible. The more efficient management then winds up taking over the less efficient because the target's assets are more valuable to the more efficient—who are thus willing to pay more for them because they will be put to better use. But many real-world outcomes contradict this (efficient capital market) theory. In the 1960s, the U.S. Supreme Court condemned some mergers precisely because they increased efficiency, in a misguided attempt to protect the merged firm's less efficient competitors. Such thinking has been implicitly abandoned, but enforcement authorities can still insist that the merged firm show that its claimed efficiencies can be achieved only through merger, rather than through some less anticompetitive means.

Merger prohibitions are the most powerful weapons against a collusion by supposed competitors that is frequently difficult to detect and defeat in other ways. The fewer the producers in the relevant market, the easier becomes an express or tacit agreement to fix prices, divide territories, etc., and to detect a cheating on this agreement. Once the number of significant competitors in the relevant market exceeds five to seven, the likelihood of such oligopolistic collusion decreases markedly, so the American enforcement authorities apply fairly high market share thresholds before they will prohibit a merger.

Like Art. 28 of Law No. 5 of 1999, Clayton Act, s.7 is silent on how high these thresholds should be for various types of mergers. American enforcement authorities thus use various indices to measure the concentration of producers in a particular relevant market, the most popular of which is currently the Herfindal-Hirschman Index (HHI). Even if a merger would be prohibited under the relevant threshold, the merged firm is often allowed to prove the defense that the efficiency gains outweigh the anticompetitive risks. But this defense seldom succeeds and, alternatively, the enforcement authorities can inquire into whether efficiency gains actually materialize after the merger.

Beyond forestalling collusion, another benefit claimed for merger prohibitions is the reduction in barriers to new producers entering the market. (New entry increases competition in the future.) The analytical problem is to define socially-harmful barriers in ways that can be measured concretely: for example, the economies of scale or superior efficiency of a merged firm may deter the entry of other producers, but Americans usually try to promote these barriers anyway. Excess capacity or dominance over an irreplaceable raw material or distribution network as a result of a merger will almost always lead to that merger being invalidated. Other entry barriers are more ambiguous in their anticompetitive effects: consider asset-specific investments (sunk costs) such as extensive advertising, and an extensive product differentiation that deprives new entrants of "niche" products that would enable them to gain a toehold in the market. American economists are agreed that almost all of the barriers to entry created by government can be safely eliminated, and the new Commission may want to advocate various deregulations for Indonesia. In any event, if a merged U.S. company can show that barriers to entry are low, the merger will likely be permitted.

The third and least substantial justification for prohibiting mergers in the U.S. is reducing the opportunities for predatory practices. The theory of predation is sufficiently dubious in economics, and the proof process is so demanding, that predation seldom succeeds as a major reason for prohibiting a merger. In any event, predatory practices can usually be discovered easily, and they can be punished separately: predatory pricing under Art. 20-21 of Law No. 5 of 1999, for example. The complexity of the economic purposes and effects of mergers have led American enforcement authorities to consider a variety of other, non-market share (non-HHI, etc.) or "soft" factors: the sophistication of consumers, etc. who are able to discipline market participants, sales methods, shipping costs, the availability of collusion-facilitating practices, a past history of collusion, a trend towards concentration in the industry, and the competitive aggressiveness previously shown by the acquired firm.

*Relevance to Indonesia*

"Rome was not built in a day", and Indonesian competition policy will not be created overnight either. To date, the U.S. and other countries continue to struggle towards a better accommodation of merger policies that necessarily conflict with each other. Gellhorn and Kovacic find that the "extraordinary ferment" in U.S. merger policy over the last twenty-five years will continue into the future. While the complexities in American and other experiences will likely prove daunting for Indonesia's new Commission, some of the foreigners' mistakes and fads can be avoided through careful analyses of what, precisely, Indonesia hopes to achieve through its merger policy, how these achievements can be bolstered by relevant theories of law and economics, and the extent to which these theories should be supplemented by political and social goals found in Art. 2-3--the *jurisprudence* of Law No. 5 of 1999. Many of these goals have been pursued at various times in the U.S., but the central message of its experiences is the primacy of attaining economic efficiency in the pursuit of public welfare—a goal listed for Indonesia under Art. 3.

While a certain amount of uncertainty and "ferment" is perhaps natural during the Commission's early days, and (American experiences show) case-by-case determinations are often the best way to deal with the complexities involved, Indonesians should also plan their policies carefully. Fair warning should be given, of the kinds of mergers that are permitted and prohibited, so that companies can plan for competition-enhancing mergers and avoid the inefficiencies of undertaking mergers that will only be struck down later. American enforcement authorities have done this through the Merger Guidelines, and these should be consulted when drafting the merger regulations called for by Art. 28(3). Indonesia should be envied for the fresh start it is making in competition policy, and Seminars like this one help to insure that it will also be a good start.